VZCZCXRO1315
RR RUEHCD RUEHGD RUEHHO RUEHMC RUEHNG RUEHNL RUEHRD RUEHRS RUEHTM
DE RUEHME #3136/01 1582012
ZNR UUUUU ZZH
R 072012Z JUN 06
FM AMEMBASSY MEXICO
TO RUEHC/SECSTATE WASHDC 1487
INFO RUEHXC/ALL US CONSULATES IN MEXICO COLLECTIVE
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 02 MEXICO 003136

SIPDIS

SENSITIVE
SIPDIS

FOR WHA/MEX AND EB/IFD/OMA
USDOC FOR 4320/ITA/MAC/WH/ONAFTA/ARUDMAN
TREASURY FOR IA - DAVID BECKWORTH

E.O. 12958: N/A
TAGS: ECON EFIN MX
SUBJECT: VOLATILITY IN MEXICAN FINANCIAL MARKETS

CORRECTED COPY - PLEASE DETROY ALL COPIES OF MEXICO 3135

Sensitive but Unclassified, Entire text.

¶1. (SBU) Summary: During the week of May 29 econoffs and FSN ECON specialist talked with a broad range of analysts and economists from foreign banks and the Mexican Stock Market. Their reading was that the recent volatility in Mexican financial markets was directly tied to capital flight from emerging markets to safer markets paying higher interest rates. But, as presidential elections draw near, the political factor has begun to play a role. Political uncertainty and fear of a victory of the Democratic Revolutionary Party's candidate, Andres Manuel Lopez Obrador (AMLO), have led a few sophisticated investors to begin taking precautions, shortening long-term positions and moving assets out of the country. Nonetheless, most sources report that Mexican economic fundamentals including a flexible exchange rate, large inflows of crude oil revenues and remittances, low interest rates, solid public finances, strong financial institutions, and prepaid foreign debt remain robust. End Summary.

HIGHER INFLATIONARY EXPECTATIONS AND INTEREST RATES
-- ------

¶2. (SBU) During the past couple of months, jitteriness has been seen in emerging financial markets, including Mexico. Inflationary risks and the fear of higher interest rates in the U.S., Europe and Japan leading to a global economic slowdown have shaken stock markets and foreign currencies worldwide. During the past three years, with excessive liquidity worldwide, investors poured money into emerging markets to capture higher interest rates. But, after hikes in commodities prices and expectations of a tighter monetary policy by the Federal Reserve, fund managers began shifting money out of high-risk markets to more secure investments, like U.S. Treasury bonds.

¶3. (SBU) All the analysts we polled indicated that the recent capital flight seen in Mexico was the result of the reduced spread between Mexican and U.S interest rates, currently at 200 bps. As Mexico's country-risk has increased from a record low of 94 bps in March to 145 bps the last week of May, local funds' strategy during the past month has been to shorten long-term positions (10-year M Bonds). Local investors are lowering their risk profile because of the fewer portfolio diversification options they have compared to foreign investors. From April to the last week of May, approximately MP 9.4 billion (USD 840 million) in Mexican government bonds held by foreign investors left the country.

For years, foreign investors have stayed in the long end of the curve, but they could decide to close these long-term positions if their perception of Mexico's political environment worsens. An optimistic Edgar Camargo, chief economist of Bank of America in Mexico, told us that he doesn't expect further foreign capital flight, at least not more than USD 500 million.

STOCK MARKET FALLS 10.5% IN MAY

¶4. (SBU) The IPC, the Mexican Stock Market's main index, fell 10.5% in May. After hitting a record of 21,822 on May 9, the IPC dropped to 18,677 at the end of the month. Alejandro Reynoso, Deputy Director and Chief Economist of the Mexican Stock Market, and the most pessimistic of the economists with whom we spoke, explained that this volatility was the result of external and domestic factors. He agreed that capital was leaving Mexico principally as a result of expected higher interest abroad. Domestically, he added that changes in regulations effective in 2005, had lifted restrictions on pension fund investment in foreign assets. To date, Siefores (Specialized Retirement Investment Societies) have invested between USD 3 and 3.5 billion in foreign securities. He noted that this was equivalent to inward foreign direct investment over the same period.

SOPHISTICATED INVESTORS CONSIDER PRECAUTIONS

¶5. (SBU) Reynoso added the uncertainty about the upcoming elections, the tie between frontrunners National Action Party candidate Felipe Calderon and Revolutionary Democratic Party candidate AMLO, miners and teachers unions' conflicts throughout Mexico, and a recent shooting at a car with Carlos

Ahumada's family inside (Ahumada is a businessman incarcerated after videos of him bribing PRD politicians were made public), have not gone unnoticed by investors. As evidence that a few sophisticated investors were growing concerned by political developments, Reynoso described a Siefore that had just pulled USD 80 million from the domestic market to buy S&P 500 index securities in an expensive transaction with an exchange rate as high as MP 11.36 to the dollar. This Siefore expected the exchange rate to climb up to MP 12.00. In a second case, one hedge fund manager called Reynoso after the June 6 morning shooting telling him that the fund would shorten its positions in Mexican securities. Reynoso is also seeing in increase in transfers of locally acquired foreign securities to U.S. banks from their branches in Mexico. More than a fraudulent scam, since these transfers are not reported to tax or money laundering authorities, Reynoso sees it as a precaution against the possibility of less market-friendly policies should AMLO win the election. Reynoso personally believed the chance of unrest arising from the election leading to a precipitous fall in Mexican markets was low, but the magnitude of such a politically driven fall would be significant enough that the most sophisticated domestic and foreign investors were taking limited defensive measures.

MARKETS' REACTION TO DIFFERENT POLITICAL SCENARIOS
--- -----

¶6. (SBU) All analysts agreed the most positive scenario for financial markets is a victory of the rightist candidate Felipe Calderon by a large margin. Markets would rise and investors would be more relaxed. The worst scenario would be if AMLO wins but fails to announce his economic team quickly (Note: Reynoso mentioned Javier Beristain, former finance secretary during PRD Cuauhtemoc Cardenas' tenure as Mexico

SIPDIS
City Mayor as a good candidate to become Secretary of Hacienda). If the Federal Electoral Institute is unable to

announce a winner the week of July 3, pressure on local financial markets will also increase. If Calderon wins by a tight margin, AMLO could take his supporters out on the street alleging fraudulent elections. Still, analysts don't expect these demonstrations to last. Reynoso felt the IPC could fall 15% and the peso could depreciate as much as 10% if AMLO continues to promote an environment of uncertainty over what his economic intentions would be as President.

¶7. (SBU) Comment: In a scenario of a shrinking money supply, risk aversion to emerging markets, and worldwide portfolio adjustments, Mexico needs a solid and stable economic policy to successfully compete against other emerging markets in attracting investments. The uncertainty of the electoral process' outcome remains a latent risk for the stability of local financial markets. There is some anecdotal evidence that local and foreign investors have reduced their Mexican exposure and there is a chance for more rebalancing if the political environment deteriorates before and after July 2. Despite the difficult and uncertain electoral process, the majority of analysts and government authorities are confident in Mexico's sound economic variables: a flexible exchange rate, large inflows of crude oil revenues and remittances, low interest rates, solid public finances, strong financial institutions, and prepaid foreign debt, which will absorb any volatility shocks. End comment.

Visit Mexico City's Classified Web Site at http://www.state.sgov.gov/p/wha/mexicocity

GARZA